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Can’t Grasp Credit Crisis? Join the Club

By David Leonhardt
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Raise your hand if you don’t quite understand this whole financial crisis.

It has been going on for seven months now, and many people probably feel as if they should understand it. But they don’t, not really. The part about the housing crash seems simple enough. With banks whispering sweet encouragement, people bought homes they couldn’t afford, and now they are falling behind on their mortgages.

But the overwhelming majority of homeowners are doing just fine. So how is it that a mess concentrated in one part of the mortgage business — subprime loans — has frozen the credit markets, sent stock markets gyrating, caused the collapse of Bear Stearns, left the economy on the brink of the worst recession in a generation and forced the Federal Reserve to take its boldest action since the Depression?

I’m here to urge you not to feel sheepish. This may not be entirely comforting, but your confusion is shared by many people who are in the middle of the crisis.

“We’re exposing parts of the capital markets that most of us had never heard of,” Ethan Harris, a top Lehman Brothers economist, said last week. Robert Rubin, the former Treasury secretary and current Citigroup executive, has said that he hadn’t heard of “liquidity puts,” an obscure kind of financial contract, until they started causing big problems for Citigroup.

I spent a good part of the last few days calling people on Wall Street and in the government to ask one question, “Can you try to explain this to me?” When they finished, I often had a highly sophisticated follow-up question: “Can you try again?”

I emerged thinking that all the uncertainty has created a panic that is partly unfounded. That said, the crisis isn’t close to ending, either. Ben Bernanke, the Federal Reserve chairman, won’t be able to wave a magic wand and make everything better, no matter how many more times he cuts rates. As Mr. Bernanke himself has suggested, the only thing that will end the crisis is the end of the housing bust.

So let’s go back to the beginning of the boom.

It really started in 1998, when large numbers of people decided that real estate, which still hadn't recovered from the early 1990s slump, had become a bargain. At the same time, Wall Street was making it easier for buyers to get loans. It was transforming the mortgage business from a local one, centered around banks, to a global one, in which investors from almost anywhere could pool money to lend.

The new competition brought down mortgage fees and spurred some useful innovation. Why, after all, should someone who knows that she's going to move after just a few years have no choice but to take out a 30-year fixed-rate mortgage?

As is often the case with innovations, though, there was soon too much of a good thing. Those same global investors, flush with cash from Asia's boom or rising oil prices, demanded good returns. Wall Street had an answer: subprime mortgages.

Because these loans go to people stretching to afford a house, they come with higher interest rates — even if they're disguised by low initial rates — and thus higher returns. The mortgages were then sliced into pieces and bundled into investments, often known as collateralized debt obligations, or C.D.O.'s (a term that appeared in this newspaper only three times before 2005, but almost every week since last summer). Once bundled, different types of mortgages could be sold to different groups of investors.

Investors then goosed their returns through leverage, the oldest strategy around. They made $100 million bets with only $1 million of their own money and $99 million in debt. If the value of the investment rose to just $101 million, the investors would double their money. Home buyers did the same thing, by putting little money down on new houses, notes Mark Zandi of Moody's Economy.com. The Fed under Alan Greenspan helped make it all possible, sharply reducing interest rates, to prevent a double-dip recession after the technology bust of 2000, and then keeping them low for several years.

All these investments, of course, were highly risky. Higher returns almost always come with greater risk. But people — by "people," I'm referring here to Mr. Greenspan, Mr. Bernanke, the top executives of almost every Wall Street firm and a majority of American homeowners — decided that the usual rules didn't apply because home prices nationwide had never fallen before. Based on that idea, prices rose ever higher — so high, says Robert Barbera of ITG, an investment firm, that they were destined to fall. It was a self-defeating prophecy.

And it largely explains why the mortgage mess has had such ripple effects. The American home seemed like such a sure bet that a huge portion of the global financial system ended up owning a piece of it. Last summer, many policy makers were hoping that the crisis wouldn't spread to traditional banks, like Citibank, because they had sold off the underlying mortgages to investors. But it turned out that many banks had also sold complex insurance policies on the mortgage debt. That left them on the hook when homeowners who had taken out a wishful-thinking mortgage could no longer get out of it by flipping their house for a profit.

Many of these bets were not huge, but were so highly leveraged that any losses became magnified. If that $100 million investment I described above were to lose just $1 million of its value, the investor who put up only $1 million would lose everything. That’s why a hedge fund associated with the prestigious Carlyle Group collapsed last week.

“If anything goes awry, these dominos fall very fast,” said Charles R. Morris, a former banker who tells the story of the crisis in a new book, “The Trillion Dollar Meltdown.”

This toxic combination — the ubiquity of bad investments and their potential to mushroom — has shocked Wall Street into a state of deep conservatism. The soundness of any investment firm depends largely on other firms having confidence that it has real assets standing behind its bets. So firms are now hoarding cash instead of lending it, until they understand how bad the housing crash will become and how exposed to it they are. Any institution that seems to have a high-risk portfolio, regardless of whether it has enough assets to support the portfolio, faces the double whammy of investors demanding their money back and lenders shutting the door in their face. Goodbye, Bear Stearns.

The conservatism has gone so far that it’s affecting many solid would-be borrowers, which, in turn, is hurting the broader economy and aggravating Wall Streets fears. A recession could cause credit card loans and other forms of debt, some of which were also based on overexuberance, to start going bad as well.

Many economists, on the right and the left, now argue that the only solution is for the federal government to step in and buy some of the unwanted debt, as the Fed began doing last weekend. This is called a bailout, and there is no doubt that giving a handout to Wall Street lenders or foolish home buyers — as opposed to, say, laid-off factory workers — is deeply distasteful. At this point, though, the alternative may be worse.

Bubbles lead to busts. Busts lead to panics. And panics can lead to long, deep economic downturns, which is why the Fed has been taking unprecedented actions to restore confidence.

“You say, my goodness, how could subprime mortgage loans take out the whole global financial system?” Mr. Zandi said. “That’s how.”